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Nos. 674 and 675

In the Supreme Court of the United States

OCTOBER TERM, 1946

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIDNEY S. MUNTER

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CARL MUNTER

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

The Acting Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that writs of certiorari issue to review the judgments of the Circuit Court of Appeals for the Third Circuit entered in the above-entitled causes on August 7, 1946.

OPINIONS BELOW

The opinion of the Tax Court (R. 24) is reported in 5 T. C. 108, and the opinion of the circuit court of appeals (R. 40) is reported in 157 F. 2d 132.

JURISDICTION

The judgments of the circuit court of appeals were entered on August 7, 1946 (R. 45–46). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the so-called *Sansome* doctrine, under which a corporate distribution is deemed a dividend when it is made from earnings and profits of predecessor companies whose assets were acquired by the successor corporation in a tax-free reorganization, applies to a situation in which new stockholders acquire, for cash, a stock interest in the successor corporation.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are printed in the Appendix, *infra*, pp. 10–19.

STATEMENT

The facts in this case were stipulated (R. 5–23) and were so found by the Tax Court (R. 25).

Their statement by the Tax Court (R. 25–27), may be summarized as follows:

On March 21, 1940, each of the taxpayers purchased, at a price of $8 per share, 10,000 shares of common stock of Crandall-McKenzie & Henderson, Inc. (hereinafter referred to as "Crandall-McKenzie"), a Pennsylvania corporation. These shares were part of a total of 38,922 shares of stock of Crandall-McKenzie issued and outstanding. There were also 11,078 shares of unissued treasury stock (R. 25).

On June 19, 1940, Crandall-McKenzie distributed to its shareholders cash in the amount of $35,166.25, at the rate of $1.25 per share. Each taxpayer received $12,500 on the 10,000 shares held by him (R. 25–26).

Crandall-McKenzie had no earnings or profits of its own accumulated from December 4, 1928, the date of its organization, to December 31, 1939, and it had no earnings or profits in the calendar year 1940 (R. 26).

Crandall-McKenzie was formed in December 1928, pursuant to an agreement between investment bankers, two predecessor corporations, Crandall-McKenzie Company (hereinafter referred to as "Crandall") and L. Henderson & Sons, Inc. (hereinafter refered to as "Henderson, Inc."), and shareholders of these corporations, O. McKenzie and L. Henderson, respectively. It acquired all the assets of the two predecessor

corporations in exchange for 24,131 shares of its stock and $355,247.75 in cash.[1] The Crandall-McKenzie stock and the cash were received by the stockholders of the two predecessor corporations in exchange for their stock therein. The remaining 25,869 shares of Crandall-McKenzie stock were issued to new interests for cash in the amount of $486,893.92 (R. 26).

All the assets of Henderson, Inc., were acquired by Crandall-McKenzie solely in exchange for 9,524 shares of its stock. At the time of acquisition, Henderson, Inc. had earnings and profits accumulated subsequent to March 1, 1913, of $74,743.62 (R. 26).

The assets of Crandall were acquired by Crandall-McKenzie for 14,607 shares of its stock and $355,247.75 in cash. At the time of acquisition, Crandall had earnings and profits accumulated subsequent to March 1, 1913, of $329,267.95 (R. 26).

From December 4, 1928, the date of its organization, to December 31, 1939, Crandall-McKenzie had aggregate earnings and profits of $401,470.07. During the same period it made aggregate cash distributions of $369,452.30 to shareholders and liquidated or purchased 11,078 shares of its own $1 stated value stock for $72,211.13 in cash. In

[1] These exchanges have been held to fall within the nonrecognition provisions of Section 112 (b) (3) and 112 (c) (1) of the Revenue Act of 1928. Appendix, *infra*, p. 11 (R. 28).

1940, it had a net loss of $37,252.47 and liquidated or purchased 12,805 shares of its stock for $94,441.90 in cash (R. 27).

The Commissioner treated the cash distribution of $12,500 each received by the taxpayers in 1940 from Crandall-McKenzie as a distribution of earnings or profits accumulated subsequent to March 1, 1913, and therefore taxable as a dividend (R. 27). The Tax Court affirmed this determination (R. 25–35), one judge dissenting (R. 35–38). The circuit court of appeals reversed the Tax Court, with one judge dissenting (R. 40–45).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the cash distribution made by Crandall-McKenzie to its stockholders was not a dividend within the meaning of Section 115 (a) of the Internal Revenue Code.

2. In holding that, after a reorganization under Section 112 (i) (1) (A) of the Revenue Act of 1928, the earnings or profits of the two predecessor corporations did not become the earnings or profits of the distributing corporation.

3. In reversing the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

In *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2), certiorari denied, 287 U. S. 667, the Circuit Court of Appeals for the Second Circuit (per L. Hand, C. J.) held that when there is a corporate reorganization which results in no gain or loss under the non-recognition provisions

of the federal income tax laws (see *e. g.*, Section 112 of the Revenue Act of 1928, Appendix, *infra*, pp. 11–13), the earnings or profits of the predecessor company remain, for purposes of distribution, earnings or profits of the successor. This decision has been followed in later decisions of the circuit courts of appeals,[2] and, in *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, this Court indicated its approval of the doctrine there announced.

Congress has, moreover, adopted the principle of the *Sansome* case and has enacted it as part of the revenue law. See Section 115 (h) of the Internal Revenue Code (Appendix, *infra*, pp. 15–16), and Sections 115l and 718 (b) (3) of the Internal Revenue Code as added by Sections 501 and 201, respectively, of the Second Revenue Act of 1940, 54 Stat. 974, 26 U. S. C. 115, 718. Indeed, Congressional committees have made specific reference to the *Sansome* decision in their reports.[3]

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[2] See, e. g., *United States* v. *Kauffmann*, 62 F. 2d 1045 (C. C. A. 9); *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641 (C. C. A. 5); *Fain* v. *Commissioner*, 76 F. 2d 1008 (C. C. A. 5), certiorari denied, 296 U. S. 588; *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2); *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2); *Corrigan* v. *Commissioner*, 102 F. 2d 1010 (C. C. A. 3), certiorari denied, 308 U. S. 576; *Gearday Enterprises* v. *Commissioner*, 126 F. 2d 384 (C. C. A. 4).

[3] Congress first incorporated the principle completely in Section 115 (h) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and has indicated its approval of the rule in connection with that and other revenue acts. S. Rep. No. 2156, 74th

In refusing to apply the *Sansome* doctrine in this case, the court below has read into it an exception for which there is no justification in the authorities. Its reliance on the fact that new stockholders bought into the successor corporation (R. 42) is misplaced. The *Sansome* doctrine rests on the proposition that a transaction which was not recognized as a sale or other disposition of corporate assets for the purpose of attributing gain or loss to the corporation conveying the assets is not to be recognized as a transaction converting accumulated profits into capital. The taxability of the distribution depends upon the source from which it came; the introduction of new capital is wholly irrelevant to this question.

The reliance of the court below on the absence of identical proprietary interests in the old corporation and the new (R. 42) is in conflict with the decision of the Circuit Court of Appeals for the First Circuit in *Putnam* v. *United States*, 149 F. 2d 721. In that case, the *Sansome* doctrine was applied although the old stockholders there "did not retain the same interest in the assets trans-

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Cong., 2d Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690), relating to Section 115 (h) of the Revenue Act of 1936; S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779, 792), relating to Section 115 (h) of the Revenue Act of 1938; H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41, 42 (1940–2 Cum. Bull. 496, 526, 527); and S. Rep. No. 2114, Part 1, 76th Cong., 3d Sess., p. 25 (1940–2 Cum. Bull. 528, 545, 548), relating to Section 501 of the Second Revenue Act of 1940.

ferred which they had before". See 149 F. 2d at 727. It is true that, in the *Putnam* case, the court said that the old stockholders "received a compensatory interest in the assets of" the new corporation "which they did not have before", and that, in that manner, "their proportionate proprietary interest was maintained": *Ibid.* But that can only mean that the stockholders of a predecessor corporation continued to have, *inter sese*, the same proportionate interests. Even if that be a relevant factor, it is equally true here. See also *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6).

The importance of the issue is manifest. There have been many non-taxable corporate reorganizations during the past few decades, and the principle has become firmly established that the earnings and profits of the predecessor corporations retain their status as earnings and profits for tax purposes in the hands of the successor corporations. Undoubtedly, many such reorganizations have been accompanied by the introduction of some new capital, and it is a matter of considerable importance that the tax status of the earnings and profits accounts of such corporations be settled, particularly in view of the foregoing conflict.[4]

[4] In reaching the result herein, the court below relied upon its prior decision in *Campbell* v. *United States*, 144 F. 2d 175, which involved not only the foregoing issue, but also the question whether the earnings and profits account had

CONCLUSION

For the foregoing reasons, this petition for writs of certiorari should be granted.

Respectfully submitted,

GEORGE T. WASHINGTON,
Acting Solicitor General.

NOVEMBER, 1946.

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been exhausted by a prior distribution of cash in connection with the reorganization. Although the taxpayers attempted to raise a similar question in this case, the Tax Court, upon the basis of this record, ruled against them (R. 34–35), and the court below expressly refrained from considering the point (R. 42, note 5).

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

(b) *Adjustment of basis.*—In computing the amount of gain or loss under subsection (a)—

(1) Proper adjustment shall be made for any expenditure, receipt, loss, or other item, properly chargeable to capital account, and

* * * * * *

(3) In the case of stock the basis shall be diminished by the amount of distributions previously made in respect of such stock, to the extent provided under the law applicable to the year in which the distribution was made.

(c) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * * *

(b) *Exchanges solely in kind.*—

* * * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) *Same—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * * * *

(c) *Gain from exchanges not solely in kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee

such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

(d) *Same—gain of corporation.*—If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of money and the fair market value of such other property so received, which is not so distributed.

* * * * *

(h) *Same—effect on future distributions.*—The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, shall not be considered a distribution of earnings or profits within the meaning of section 115(b) for the pur-

pose of determining the taxability of subsequent distributions by the corporation.

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS

* * * * *

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital ac-

count shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

* * * * *

(h) *Definition of partial liquidation.*— As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

* * * * *

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) [as amended by Public Salary Tax Act of 1939, c. 59, 53 Stat. 574, Sec. 1] *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall

not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115. (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * *

(26 U. S. C. 115.)

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 578. *Source of distribution of stock or securities.*—The general rule, provided in section 115 (b), that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to a distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or of stock or securities in a corporation a party to the reorganization. Such a distribution will not be considered a distribution of earnings or profits in determining the amount of earnings and profits accumulated since February 28, 1913, which are available for distribution and which under section 115 (b) must be distributed before earnings

and profits accumulated before March 1, 1913, may be distributed exempt from tax.

Example: The X Corporation has a capital of $100,000, earnings and profits accumulated prior to March 1, 1913, of $25,000, and earnings and profits of $50,000 accumulated after February 28, 1913. It causes the organization of the Y Corporation, to which it transfers $50,000 of its assets in exchange for all of the stock of the Y Corporation. It then distributes the stock of the Y Corporation as a dividend to its shareholders. No gain to the shareholders from the receipt of this stock will be recognized under the provisions of section 112 (g) and article 576, nor will the distribution be considered a distribution of earnings or profits in determining the amount of earnings and profits accumulated since February 28, 1913, on hand for a subsequent distribution as a dividend.

The provisions of this article apply to the case in which the X Corporation distributes the stock of the Y Corporation as a dividend, the case in which the X Corporation distributes the stock of the Y Corporation in retirement of a portion of the stock of the X Corporation, and the case in which the Y Corporation issues its stock direct to the shareholders of the X Corporation.

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.115–2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most

recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given *first*, to the earnings or profits of the taxable year; *second*, to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; *third*, to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, *fourth*, to sources other than earnings or profits only after the earnings or profits have been distributed.

* * * The portion of each such distribution which is not regarded as out of earning or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made. * * *

* * * * * *

SEC. 19.115–9. *Distribution in redemption or cancellation of stock taxable as a dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend.

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